

Equitable Lien
Constructive Trust
Subrogation
Surety
Tracing

Amwest Surety Insurance Co. v. U.S. Nat. Bank et al. 96-6117-fra
(In re Comcraft, Inc. 695-63697-fra7)

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The debtor was a contractor which contracted with the Bethel School District to install a phone system. Pursuant to state law, the debtor obtained payment and completion bonds from the Plaintiff, Amwest. The debtor subsequently filed for Chapter 11 bankruptcy and, shortly thereafter, received the final progress payment from Bethel which was deposited into the debtor's cash collateral account. A cash collateral order was subsequently stipulated to by secured lenders, without Amwest's participation, and approved by the court. The agreement allowed USNB a security interest in the debtors A/R, among other things. The debtor defaulted in payments to subcontractors on the Bethel job and Amwest was forced to pay pursuant to its bond. The case was thereafter converted to Chapter 7. Both USNB and Amwest claimed an interest in the Bethel funds deposited to the debtor's cash collateral account; USNB by virtue of its security interest and Amwest because it was forced to pay on its bond.

The court held that the surety had an equitable lien against moneys which Bethel paid to the contractor which continued until the contractor fulfilled its duty with respect to payment of subcontractors and materialmen. In addition, the subcontractors had a contractual right pursuant to the requirements of state law to receive payment from the actual funds paid by Bethel to the contractor. This gave rise to a constructive trust in favor of the unpaid subcontractors and materialmen to which Amwest was subrogated when it paid the claims. Amwest's right to the funds was held to be superior to that of USNB. Using the lowest intermediate balance method of tracing the Bethel payment, the court held that Amwest was entitled to the remaining funds held by the trustee.

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8 UNITED STATES BANKRUPTCY COURT
9 FOR THE DISTRICT OF OREGON

10 IN RE)
11 COMCRAFT, INC.,) Case No. 695-63697-fra7
12 Debtor.)
13 AMWEST SURETY INSURANCE CO.,)
14 Plaintiff,)
15 vs.) Adversary No. 96-6117-fra
16 U.S. NATIONAL BANK OF OREGON;)
17 BOYD C. YADEN, Trustee, for)
18 Bankruptcy Estate of Comcraft,)
Inc.,)
Defendants.) MEMORANDUM OPINION

19 I. INTRODUCTION

20 Comcraft, Inc., the Debtor, was a contractor specializing in
21 the installation of business telephone systems. At the time it
22 filed its petition for relief, one of its major projects was the
23 installation of a phone system for the Bethel School District
24 ("Bethel"). Plaintiff Amwest Surety Insurance Co. ("Amwest")
25 issued the payment and completion bonds required by state law for
26 public construction projects. Defendant United States National

1 Bank ("USNB") is a secured creditor of Comcraft's. This case
2 involves the competing claims of the surety and the secured
3 creditor to funds paid by Bethel to Comcraft, and retained by
4 Comcraft, after its Chapter 11 petition was filed. I find that,
5 under Oregon law, the surety's right is superior to that of the
6 lender.

7 II. PROCEDURAL ISSUES

8 Amwest seeks a declaratory judgment to the effect that it is
9 entitled to receive the balance of the monies paid by Bethel to
10 Comcraft now held by Comcraft's chapter 7 trustee. USNB raised
11 several defenses, which will be discussed below. The Trustee and
12 NEC America, another secured creditor, were joined as defendants
13 but have not participated in the case.

14 Amwest and USNB have filed cross-motions for summary judgment.
15 The motions were accompanied by extensive documentation. Amwest
16 submitted a detailed "Concise Statement of Material Facts",
17 pursuant to Local Bankruptcy Rule 220-9. USNB did not submit
18 such a statement prior to oral argument. However, it did submit
19 a "Supplemental Concise Statement of Material Facts" after
20 argument. Amwest objects, and asks that USNB's statement be
21 disregarded. In the alternative, it seeks leave to respond to
22 the statement.

23 The purpose of the rule requiring a concise statement of facts is
24 to assist the court in analyzing the parties' motions by pointing
25 the way to those items supporting the movant's claims. The Court
26 may, but is not required to limit its review to the concise

1 statement.¹ The court may, in its discretion, permit additional
2 or -- as here -- untimely statements if doing so will enhance its
3 ability to afford the parties a complete review of the issues
4 before it. To do so does not constitute a reopening of the
5 record, since the concise statement is no more than a guide to
6 the evidentiary record created by the parties' supporting
7 affidavits. However, the allowance of an untimely statement
8 relieves the party submitting it of the effect of failing to
9 controvert the moving party's statement. See LBR 220-9(f).
10 Summary judgment is appropriate when the pleadings, discovery
11 responses, and supporting affidavits show that there is no
12 genuine issue as to any material fact, and that the moving party
13 is entitled to a judgment as a matter of law. FRBP 7056,
14 incorporating FRCP 56. Based on the record now before the court,
15 including both parties' concise statements of material facts, it
16 appears that the material facts are undisputed.

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20 ¹ LBR 220-9 states, in part:

21 (e) Scope of Judicial Review: Except as
22 otherwise required by law, when resolving
23 motions for summary judgment, the court shall
24 have no independent duty to search and
25 consider any part of the court record not
26 otherwise referenced in the separate concise
statements of the parties.

(f) Admission of Material Facts: For
purposes of a motion for summary judgement,
material facts set forth in the concise
statement of the moving party will be deemed
admitted unless controverted by a separate
concise statement of the opposing party.

1 III. FACTS

2 On June 14, 1995 Comcraft contracted with the Bethel School
3 District ("Bethel") to upgrade Bethel's telephone system and
4 provide wiring for a voice and data system. The combined value
5 of these contracts was \$439,954.11. Plaintiff issued payment and
6 performance bonds for each of the contracts.

7 Comcraft commenced performance under the contracts the same
8 month, and had substantially completed performance prior to its
9 bankruptcy petition on September 26, 1995.

10 In the course of its efforts under the Bethel contract, Comcraft
11 obtained materials from NEC, Graybar and Applied Voice
12 Technology. The sale of the goods required payment within 30
13 days of delivery. Comcraft failed to pay for the materials
14 within the time provided, and each of the suppliers gave notice
15 of bond claims to Plaintiff after the bankruptcy petition was
16 filed.

17 As noted, Comcraft filed a petition for relief under Chapter 11
18 of the Bankruptcy Code on September 26, 1995. Three days later,
19 on September 29, Bethel made a progress payment to Comcraft in
20 the amount of \$178,051.39. An additional \$1,039.98 was paid on
21 October 23, 1995. By that time the contract had been
22 substantially completed.

23 At the time the petition for relief was filed, Defendant USNB had
24 a valid and perfected security interest in Comcraft's accounts.
25 The security interest extended to the proceeds of the contract
26 paid by Bethel to Comcraft. Since Comcraft required the use of

1 the proceeds to continue its operations, it applied for an order
2 permitting use of USNB's cash collateral. Hearings on the motion
3 were held on October 1, October 11, and October 26, 1995. A
4 stipulation between USNB, NEC, and the Debtor for the use of cash
5 collateral was entered at the October 26 hearing. Thereafter
6 Debtor used a portion of the cash collateral for post-petition
7 labor and materials on the Bethel contracts in the amount of
8 \$10,668.20. The balance of the funds expended were used for
9 unrelated purposes.

10 By November 4, 1995 Amwest had asserted its right to the proceeds
11 of the contract. At a hearing on November 4, 1995 the parties
12 agreed to freeze the funds on deposit in the Debtor-in-
13 Possession's cash collateral account pending a determination of
14 the respective rights of Amwest and USNB.

15 In June 1996 Plaintiff made payments to suppliers of Comcraft in
16 connection with the Bethel contract totaling \$217,556.22. An
17 additional \$3,306.16 was paid directly to Bethel on the
18 performance bond claim.

19 The case was converted to Chapter 7 on November 21, 1995. During
20 the course of the Chapter 11 case a total of \$293,640.96 was
21 deposited by Comcraft to its cash collateral account; of that
22 sum, \$179,091.37 is attributable to the Bethel School District
23 contract.

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1 IV. ANALYSIS

2 Priority of Claims to Funds

3 The Chapter 7 trustee now holds the balance of the funds
4 paid by Bethel to the Debtor. Plaintiff's complaint and motion
5 for summary judgment seek a determination that it has a superior
6 claim to these funds.

7 The competing claims of the bank and the surety are governed
8 by state law. In re Dahlquist, 34 B.R. 476, 484 (Bankr. D. S.D.
9 1983). Oregon law is thoroughly discussed in a leading case in
10 this area, In re Pacific Marine Dredging and Construction, 79 BR
11 924 (Bankr. D. Or. 1987). In that case the plaintiff was a
12 county service district, and owner of a project in which the
13 debtor was a contractor. The debtor had substantially completed
14 the contract, but had failed to pay several subcontractors. The
15 subcontractor's claims were eventually paid by the surety. Given
16 the competing claims of the surety and the secured creditor, the
17 owner initiated an adversary proceeding interpleading the funds.

18 Citing to an "unbroken line of cases" from the Oregon
19 courts, the Pacific Marine court held that Oregon law provides
20 that a surety which executes a bond on a public contract has an
21 equitable lien on funds the owner properly withholds from the
22 contractor. 79 BR at 928. The lien is created when the bond is
23 executed and continues until the general contractor has fulfilled
24 all of his obligations under the contract. Id. at 929. It
25 follows that the lien is superior in priority to that of the
26 contractor's secured lender. The holding was consistent with

1 that of the District Court in United Pacific Ins. v. First
2 National Bank of Oregon, 222 F. Supp. 243 (D. Or. 1963).

3 The instant case differs from Pacific Marine in one respect:
4 the fund in question was not retained by the project owner, but
5 paid to the contractor. This does not change the result. A
6 surety which is forced to pay a bond claim is subrogated to the
7 subcontractor or materialman's claim against the contractor in
8 existence immediately prior to the payment. New Amsterdam
9 Casualty Co. v. City of Astoria et al. 256 F. 560 (D. Or. 1919);
10 Mayer v. First National Bank of Oregon, 260 Or. 119, 130, 489
11 P.2d 385, 391 (1971). The purpose of the equitable lien is to
12 protect that right. Since the lien exists to protect the
13 surety's subrogation right, it remains in effect as long as the
14 right does. The right subrogated to is the subcontractor's claim
15 against the contractor; payment of the funds by the owner to the
16 contractor does not diminish that right. It follows that the
17 lien follows the funds into the hands of the contractor. This
18 result is supported by the strong public policy in Oregon
19 supporting the surety's claims. United Pacific Ins. v. First
20 National Bank of Oregon, 222 F. Supp. 243, 250 (D. Or. 1963), In
21 re Pacific Marine Dredging and Construction, 79 BR 924, 928
22 (Bankr. D. Or. 1987).

23 USNB argues that Amwest's subrogation rights vanished when
24 Bethel paid Comcraft, because Bethel's rights vanished when it
25 disbursed the funds. However, Amwest did not pay Bethel, it paid
26 the subcontractors, and it is the subcontractors' claims to which

1 Amwest was subrogated. These claims remained viable after
2 Comcraft was paid.

3 USNB also cites to a series of cases in which the secured
4 creditor prevails. In these cases the funds had either been paid
5 over to the secured creditor or the court relied on state law or
6 contract provisions not relevant in this case. In this case, the
7 funds are in the hands of the bankruptcy trustee; these cases are
8 not controlling.

9 USNB's Defenses

10 USNB claims that, even if Amwest has a valid lien, it is
11 barred from asserting it. It claims, in essence, that Amwest had
12 a duty to assert its claim to the funds paid to Comcraft before
13 the entry of the cash collateral order. Had it done so, USNB,
14 having become aware to the surety's claim, would not have
15 consented to the use of its collateral.

16 This misses an important point: the funds were the surety's
17 collateral as well. While USNB states that it would not have
18 agreed to the use of its cash collateral if it had been aware
19 that Amwest had a superior right to the Bethel funds, Amwest was
20 directly injured by the debtor's use of the funds since the
21 balance remaining on hand is less than the amount paid by Amwest
22 to the subcontractors. USNB could have protected itself by
23 requiring that the Bethel funds, which it knew to be bonded, be
24 deposited to a separate account and used to pay bonded debt.
25 This was not done. The equities do not favor USNB as it asserts.

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1 Constructive Trust

2 O.R.S. 279.312(1) requires that every public contract
3 contain a condition that the contractor "make payment promptly,
4 as due, to all persons supplying to such contractor labor or
5 material for the prosecution of the work provided for in such
6 contract." This provision is included in the construction
7 contract between the Bethel School District and the contractor,
8 Comcraft, at ¶9.6.2: "The Contractor shall promptly pay each
9 Subcontractor, upon receipt of payment from the Owner [Bethel],
10 out of the amount paid to the contractor on account of such
11 Subcontractor's portion of the Work, the amount to which said
12 Subcontractor is entitled. . . ." This contractual provision
13 obligates the contractor, Comcraft, to make payments to
14 Subcontractors out of the payment received by the owner, Bethel.

15 Even more importantly, O.R.S. 279.445(4)(a) requires that
16 every public contract contain "[a] payment clause that obligates
17 the contractor to pay the subcontractor for satisfactory
18 performance under its subcontract within 10 days out of such
19 amounts as are paid to the contractor by the public contracting
20 agency under such contract." [Emphasis added]. Clearly, Oregon
21 law gives subcontractors a right to be paid by the contractor
22 from the specific proceeds of a publicly funded project. This is
23 the right to which Amwest was subrogated when it paid the
24 subcontractors.

25 The doctrine of constructive trusts, as well as of equitable
26 liens, has long been recognized by Oregon courts. In re Angus, 9

1 B.R. 769 (Bankr. D. Or. 1981) (citing Hughes v. Helzer 182 Or.
2 205, 185 P.2d 537 (1947); Oregon Mutual Insurance Co. v.
3 Cornelison, 214 Or. 501, 330 P.2d 161 (1958)). Because the
4 contractor, Comcraft, had an obligation to pay the subcontractors
5 out of the proceeds of the Bethel contract and Amwest, as
6 subrogee to the subcontractors it paid, has an independent right
7 to be paid from those funds, the funds in question, to the extent
8 still held by the bankruptcy trustee, are impressed with a
9 constructive trust to make such payments.

10 Tracing

11 USNB argues that even if Amwest were found to be entitled to
12 the progress payment from Bethel in the hands of the contractor,
13 those funds were commingled with other funds in the cash
14 collateral account and have already been, to a large extent,
15 expended using a first-in-first-out method of tracing the funds.
16 USNB asserts that this tracing method, or a pro-rata method,
17 should be used in cases such as this where equity does not favor
18 either of the competing parties.

19 Amwest argues that the "lowest intermediate balance" tracing
20 method should be used. That method has evolved from the
21 equitable principals of trusts and is recognized in the Ninth
22 Circuit. See Republic Supply Co. of California v. Richfield Oil
23 Co. of California, 79 F.2d 375, 380 (9th Cir. 1935); In re R & T
24 Roofing Structures & Commercial Framing, Inc., 887 F.2d 981, 987
25 (9th Cir. 1989). All parties agree that the lowest intermediate
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1 balance method will result in Amwest being entitled to all the
2 remaining funds being held by the trustee.

3 Amwest has an equitable lien against the progress payment
4 from Bethel in the hands of the contractor and Amwest is, in
5 effect, a third party beneficiary to the progress payment which
6 was impressed with a constructive trust in favor of the
7 subcontractors. Public policy favors protection of sureties'
8 interests so as to encourage those to act as surety on public and
9 other construction work. See generally United Pacific Insurance
10 Co. v. First National Bank of Oregon, 222 F.Supp. 243 (D.Or.
11 1963); Tri-City Service District v. Pacific Marine Dredging and
12 Construction, 79 B.R. 924 (Bankr. D.Or. 1987). In addition,
13 public policy also favors protection of subcontractors and
14 materialmen on publicly funded projects as evidenced by the
15 requirements that all public contracts be bonded and that public
16 contracts obligate the contractor to pay subcontractors and
17 materialmen from the proceeds of the contract. Given the above,
18 and the general equities involved, the lowest intermediate
19 balance method is the appropriate tracing method to determine how
20 much of the Bethel payment remains in the hands of the trustee
21 and is thus payable to Amwest. As stated above, Amwest is
22 therefore entitled to the remaining funds held in the cash
23 collateral account by the Chapter 7 trustee.

24 V. CONCLUSION

25 Amwest is entitled to the remaining funds held by the
26 trustee in the debtor's cash collateral account due to the

1 equitable lien it holds against those funds as surety and as
2 subrogee to the rights of the subcontractors which it paid
3 pursuant to its bond. Consequently, Amwest's motion for summary
4 judgment is granted and USNB's motion is denied. Amwest shall
5 submit an order consistent with this opinion.

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9 FRANK R. ALLEY, III
10 Bankruptcy Judge
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